



Audit

Report



COMPILING AND REPORTING FY 1999
DEPARTMENT OF THE NAVY WORKING CAPITAL FUND
INTRAGOVERNMENTAL TRANSACTIONS

Report No. D-2000-144

June 09, 2000

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Acronyms

DFAS	Defense Finance and Accounting Service
IG	Inspector General
OMB	Office of Management and Budget
USD(Comptroller)	Under Secretary of Defense (Comptroller)



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2885

June 9, 2000

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
AND CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on Compiling and Reporting FY 1999 Department of the
Navy Working Capital Fund Intragovernmental Transactions
(Report No. D-2000-144)

We are providing this report for review and comment. The Under Secretary of Defense (Comptroller) provided combined comments for his office and the Defense Finance and Accounting Service, and we considered those comments in preparing the final report. We conducted the audit in support of our annual audit of DoD Agency-wide financial statements for FY 1999 as required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Comments by the Under Secretary of Defense (Comptroller) were partially responsive. We request the Under Secretary of Defense (Comptroller) comment on Recommendation 1.a. and the Director, Defense Finance and Accounting Service, comment on Recommendations 2.a. through f. by August 9, 2000.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. Marvin L. Peek at (703) 604-9587 (DSN 664-9587) (mpeek@dodig.osd.mil) or Mr. Hoa H. Pham at (703) 604-9588 (DSN 664-9588) (hpham@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed inside the back cover.

A handwritten signature in cursive script, reading "Robert J. Lieberman", is positioned above the typed name.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2000-144

June 9, 2000

(Project No. D2000FC-0045.003)

Compiling and Reporting FY 1999 Department of the Navy Working Capital Fund Intragovernmental Transactions

Executive Summary

Introduction. We conducted this audit in support of our annual audit of the DoD Agency-wide financial statements for FY 1999, as required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. This report is the third report in a series on the Department of the Navy (Navy) Working Capital Fund financial statements. During FY 1999, the Navy Working Capital Fund reported \$23.4 billion in assets, \$5.5 billion in liabilities, \$17.9 billion in net position, and \$21.8 billion in intragovernmental transactions. Intragovernmental transactions are transactions that occur within and among DoD Components and agencies, and the Federal Government. Intragovernmental transactions should be identified or eliminated, as appropriate, when an entity prepares consolidated financial statements.

Objectives. The audit objective was to determine whether the Defense Finance and Accounting Service Cleveland Center consistently and accurately compiled and reported intragovernmental transactions for the FY 1999 Navy Working Capital Fund financial statements. We also reviewed the Defense Finance and Accounting Service Cleveland Center management control program as it related to our objective.

Results. The Defense Finance and Accounting Service Cleveland Center made a commendable effort in identifying and reporting \$21.8 billion in intragovernmental transactions for the FY 1999 Navy Working Capital Fund financial statements in accordance with Office of Management and Budget requirements. However, the intragovernmental transactions of \$21.8 billion reported in the Navy financial statements were inaccurate and unreliable. The Cleveland Center did not have complete audit trails for seven adjustments, totaling \$16.2 billion, of the eight adjustments made to the departmental level general ledger accounts. Also, the Cleveland Center did not fully disclose the reason for allocating the entire \$213 million in undistributed collections. In addition, the Cleveland Center did not explain the reasons for allocating the \$405 million in accounts receivable and \$70 million in unearned revenue to 29 Navy Industrial Fund organizations in the notes to the financial statements. As a result, the FY 1999 financial statements of the Navy Working Capital Fund were subject to misstatement and could not be relied on to be a complete and accurate representation of financial reporting. The FY 1999 DoD Agency-wide financial statements were also similarly affected.

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) finalize draft policy guidance on how the finance and accounting centers should accumulate and report intragovernmental transactions. We also recommend that the Director, Defense Finance and Accounting Service Cleveland Center, maintain audit trails for all intragovernmental accounts receivable, revenue, and unearned

revenue obtained from other trading partners for all levels; reconcile seller-side and buyer-side information; and document procedures used to collect, verify, and report intragovernmental transactions.

Management Comments. The Under Secretary of Defense (Comptroller) partially concurred with the recommendations in a combined response for his office and the Defense Finance and Accounting Service. The comments emphasized that identification and elimination of intragovernmental transactions is a Government-wide problem, additional Government-wide guidance is needed, and DoD financial systems are not capable of producing the required information to properly eliminate intragovernmental transactions. Given the large number of intragovernmental transactions, relying on "after-the-fact" reconciliations is not feasible. Until adequate accounting systems are in place and more detailed Government-wide guidance is issued, DoD plans to issue interim procedures allowing the use of estimates based on percentage allocations of summary balances. New interim policy and procedural guidance will be included in the DoD form and content guidance for audited financial statements in DoD Regulation 7000.14-R to aid in the elimination of intragovernmental balances.

In regard to the recommendations to the Defense Finance and Accounting Service, the Under Secretary of Defense (Comptroller) stated that DoD will implement interim policies and procedures to provide a "meaning approximation" of intragovernmental transactions. The policies are to address the existence of audit trails, data integrity, accuracy, and management controls. The Defense Finance and Accounting Service is working on implementation strategies to better ensure that journal vouchers are properly supported. See the Finding section for additional discussion of management comments and the Management Comments section of the report for the complete text of the comments.

Audit Response. The comments from the Under Secretary of Defense (Comptroller) are responsive concerning the active involvement of his office in interagency workgroups to develop policy, expected issue of interim intragovernmental elimination policy guidance to enhance the process, and the continued work to develop accounting systems to capture the required data. However, reliability of the DoD and Government-wide consolidated financial statements will be adversely affected until intragovernmental transactions can be identified and eliminated, as required by the Office of Management and Budget.

The Under Secretary of Defense (Comptroller) did not comment on the recommendation to disclose unreconciled amounts in the notes to the financial statements. We request the Under Secretary provide additional comments on that recommendation. Also, the comments did not specify the actions to be taken on the recommendations to the Defense Finance and Accounting Service Cleveland Center. Therefore, we request the Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, provide comments on the final report by August 9, 2000.

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Background

Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, requires DoD to submit to the Office of Management and Budget (OMB) annual financial statements that have been audited by the Inspector General (IG), DoD. This report is the third in a series of reports related to the FY 1999 Department of the Navy¹ Working Capital Fund financial statements. This report discusses the reliability and effectiveness of the policies and procedures used to report intragovernmental transaction information for FY 1999 Navy Working Capital Fund financial statements.

Accounting Functions and Responsibilities. The Defense Finance and Accounting Service (DFAS) Cleveland Center provides finance and accounting support to the Navy Working Capital Fund.² Each month, DFAS Cleveland Center receives financial information in various forms from Navy Working Capital Fund field organizations and records the data into the central database accounting system. The DFAS Cleveland Center consolidates the financial data for each activity group and prepares both the monthly reports and annual financial statements for the Navy Working Capital Fund. The FY 1999 Navy Working Capital Fund financial statements reported assets of \$23.4 billion, liabilities of \$5.5 billion, and a net position of \$17.9 billion.

Transactions Requiring Elimination. Intragovernmental transactions are transactions that occur within and among DoD Components and agencies, and the Federal Government. When an entity prepares consolidated financial statements, it should eliminate the effect of financial transactions among its components and should report only transactions with outside parties. The Navy Working Capital Fund organizations are routinely involved in transactions involving sales and purchases of materials and services with other Navy General Fund and Working Capital Fund organizations, DoD Components, and other Federal agencies. When those kinds of transactions occur, the transactions are to be closed, and when appropriate, eliminated from the various levels of financial statements. With regard to sales of goods or services between Federal entities, there are three levels of intragovernmental transactions, which must be identified:

- Level 1: Transactions involve sales between DoD and other Federal agencies, such as between the Navy and the Department of Commerce.
- Level 2: Transactions involve sales between DoD reporting entities, such as between the Navy Working Capital Fund and the Navy General Fund.

¹The Department of the Navy includes both the Navy and Marine Corps. However, in this report, the term "Navy" will refer to the Department of the Navy.

²The Navy Working Capital Fund consists of 9 activity groups: 7 Industrial Fund activity groups composed of 48 organizations, the Marine Corps, and Supply Management.

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- Level 3: Transactions involve sales between components of the DoD financial reporting entities, such as between the Navy Working Capital Fund Supply Management and the Navy Working Capital Fund Depot Maintenance.

During FY 1999, DFAS Cleveland Center identified \$21.8 billion in intragovernmental transactions for levels 1, 2, and 3. Of the \$21.8 billion, \$357.7 million in receivables, \$441.6 million in unearned revenue, and \$2.6 billion in revenue were eliminated from the FY 1999 Navy Working Capital Fund financial statements.

Objectives

The audit objective was to determine whether DFAS Cleveland Center consistently and accurately compiled and reported intragovernmental transactions for the FY 1999 Navy Working Capital Fund financial statements. We also reviewed the DFAS Cleveland Center management control program as it related to our objective. Appendix A discusses the audit scope and methodology and our review of the management control program.

Intragovernmental Transactions

The DFAS Cleveland Center was able to identify and report \$21.8 billion in intragovernmental transactions for the FY 1999 Navy Working Capital Fund financial statements in accordance with the OMB requirement. However, the reported intragovernmental transactions were inaccurate and unreliable. The Cleveland Center did not have complete audit trails for seven adjustments, totaling \$16.2 billion, of the eight adjustments made to the departmental level general ledger accounts. Also, DFAS Cleveland Center did not fully disclose the reason for allocating the entire \$213 million in undistributed collections to level 3. In addition, the Cleveland Center did not disclose the reason for allocating the entire \$405 million in accounts receivable and \$70 million in unearned revenue to 29 Navy Industrial Fund organizations in the notes to the financial statements. The reported intragovernmental transactions were inaccurate and unreliable because DFAS Cleveland Center and other DoD accounting offices did not have adequate financial management systems for compiling adequate financial data, and the Under Secretary of Defense (Comptroller) (USD[Comptroller]) did not develop and issue effective guidance in a timely manner to compensate for the limitations in current DoD accounting systems. Also, many Navy Industrial Fund organizations did not comply with the DFAS Cleveland Center requirement to expand the summary source of revenue to include accounts receivable and unearned revenue. Also, the conditions occurred because DFAS Cleveland Center did not do the following:

- establish the management controls needed to ensure that the process used to accumulate, adjust, and report intragovernmental transactions was thoroughly documented and fully complied with DoD Regulation 7000.14-R, "Financial Management Regulation"; and
- fully implement interim guidance for identifying and reporting intragovernmental transactions when compiling information for the intragovernmental transactions.

As a result, the FY 1999 financial statements for the Navy were subject to misstatement and could not be relied on to be a complete and accurate presentation of financial reporting. The FY 1999 DoD Agency-wide consolidated financial statements were also similarly affected.

Guidance for Reporting Intragovernmental Transactions

OMB Guidance. OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, amended on November 20, 1998, requires agencies to show intra-entity eliminations for FY 1999. The amendment to the policy was in effect for the FY 1999 consolidated financial

statements of the United States and all DoD financial statements. Additionally, Technical Amendment to OBM Bulletin 97-01, January 7, 2000, requires reporting entities to reconcile intragovernmental asset, liability, and revenue amounts reported in the required supplementary information with their trading partners at least annually as of the end of each fiscal year.

DoD Guidance. To implement the OMB reporting requirements, each fiscal year, DoD develops and issues policy for the Military Departments and Defense agencies to implement in preparing their financial statements. Because of the systemic problems in the DoD accounting and financial management systems, DoD Regulation 7000.14-R, volume 6B, "Form and Content of the Department of Defense Audited Financial Statements," is updated annually to reflect the progress made to DoD current accounting systems. For FY 1999, volume 6B was updated in October 1999. However, the implementation guidance on intragovernmental transactions was not included in volume 6B. In November 1999, the USD(Comptroller) issued draft guidance on intragovernmental transactions. However the draft guidance was not finalized prior to issuance of this audit report.

DFAS Interim Guidance. DFAS published a draft of chapter 13 to volume 6B, DoD Regulation 7000.14-R, on August 31, 1999 (hereafter referred to as DFAS interim guidance). The DFAS interim guidance was issued as a result of the recommendation we made in IG, DoD, Report No. 98-204, "Reporting and Disclosing Intragovernmental Transactions for the FY 1997 DoD Consolidated Financial Statements," September 21, 1998, and the Naval Audit Service Report No. 048-99, "Fiscal Year 1998 Department of the Navy Principal Statements and Working Capital Fund Consolidated Financial Statements Eliminating Entries," July 22, 1999.

The guidance requires that DoD accounting centers and DoD Components work internally, and with their customers, to extract seller-side information from their intragovernmental (DoD and non-DoD) trading partners because DoD presumed that the amounts of intragovernmental accounts receivable, revenue, and unearned revenue reported by the seller are correct. Furthermore, the guidance states that specific seller-side intragovernmental balances should be exchanged and compared with summary buyer-side data at the appropriation or Defense Working Capital Fund business-area level in an effort to review and adjust intragovernmental activity and prepare annual financial statements that eliminate the effect of intra-entity transactions. Because the Under Secretary of Defense (comptroller) had not finalized its draft guidance, DFAS Headquarters instructed all the DFAS centers to use the DFAS interim guidance to accumulate and report FY 1999 intragovernmental transactions.

Processing Intragovernmental Transactions

Table 1 shows a breakout of intragovernmental data shown in worksheets prepared by DFAS Cleveland Center for the Navy Working Capital Fund.

Table 1. Summary of Seller Data Used for Intragovernmental Transactions (dollars in thousands)				
Elimination <u>Level</u>	<u>Accounts Receivable</u>	<u>Revenue</u>	<u>Unearned Revenue</u>	<u>Total</u>
Level 1	\$ 69,742	\$ 638,014	\$ 95,119	\$ 802,875
Level 2	395,864	16,829,521	324,766	17,550,151
Level 3	<u>357,688</u>	<u>2,627,658</u>	<u>441,596</u>	<u>3,426,942</u>
Total	\$823,294	\$20,095,193	\$861,481	\$21,779,968

However, the process that DFAS Cleveland Center used to account for the \$21.8 billion in intragovernmental transactions did not accurately identify and eliminate the effects of all intragovernmental transactions that occurred within and among Navy Working Capital Fund organizations, DoD, and other Federal agencies.

Adjusting to the Seller Records. Because of the lack of reliable accounting and financial information, DFAS Cleveland Center was unable to use the data in the departmental level general ledger accounts as a source for accumulating, eliminating, and reporting intragovernmental transactions. Instead, DFAS Cleveland Center used the seller information on accounts receivable, revenue, and unearned revenue as a basis for reporting intragovernmental transactions. However, using the sellers' information to report intragovernmental transactions resulted in a series of adjustments because the amounts recorded for accounts receivable, revenue, and unearned revenue in the sellers' records differed from the amounts recorded in the departmental level general ledger accounts. For example, DFAS Cleveland Center had to make eight adjustments to the departmental level general ledger accounts totaling \$16.4 billion to match the buyers' records to the sellers' records.

Audit Trails for Intragovernmental Transactions. The DFAS Cleveland Center did not have complete audit trails for the \$21.8 billion in intragovernmental transactions reported in the FY 1999 Navy Working Capital Fund consolidated financial statements. The lack of complete audit trails occurred largely because DFAS interim guidance did not require DoD accounting centers and DoD Components to reconcile seller-side and buyer-side information. DoD Regulation 7000.14-R, volume 1, "General Financial Management Information, Systems and Requirements," June 1999, chapter 3, requires that audit trails

including documentation be maintained so that auditors can ensure that transactions are properly accumulated, classified, coded, and recorded in all affected accounts and later reported in the proper financial statements. DFAS Cleveland Center adjusted the buyers' general ledger accounts to match the sellers' records without proper research and reconciliation to determine the reasons for the differences and did not always obtain complete information from the sellers for levels 1, 2, and 3. Examples follow.

- DoD Regulation 7000.14-R, volume 6B, chapter 4, states that accounts receivable is the amount that the Federal entity claims for payment from other Federal organizations net of undistributed collections. To comply with guidance, DFAS Cleveland Center reduced accounts receivable by \$213 million. However, because the departmental level general ledger accounts did not have detailed information that would enable accounting personnel to properly allocate the \$213 million in undistributed collections to each level, DFAS Cleveland Center decided to allocate the entire \$213 million in undistributed collections to level 3.
- DFAS interim guidance requires that the DoD accounting centers and DoD Components work internally, and with their customers, to extract seller-side information from their intragovernmental (DoD and non-DoD) trading partners. The guidance does not require the centers to reconcile seller-side and buyer-side information because it presumed that the amounts of intragovernmental accounts receivable, revenue, and unearned revenue that the seller reported were correct. To comply with the guidance, DFAS Cleveland Center requested Navy organizations to modify their Summary Source of Revenue report to include accounts receivable, revenue, and unearned revenue. However, 60 percent of the Navy organizations did not submit information for accounts receivable and unearned revenue totaling \$405 million and \$70 million, respectively. Accordingly, DFAS Cleveland Center decided to allocate the entire amounts of accounts receivable and unearned revenue reported in the general ledger to level 3.

As a result, the portion of \$213 million of undistributed collections, \$405 million of accounts receivable, and \$70 million of unearned revenue were overstated for level 3 and understated for levels 1 and 2.

Reasons for Unreliable Reporting of Intragovernmental Transactions

The lack of adequate financial management systems to accurately accumulate and report financial information was the primary cause of unreliable intragovernmental transactions. Also, the lack of policy guidance by DoD and the inability to comply with DFAS interim guidance contributed to the unreliability of reported intragovernmental transactions.

Reliability of Accounting and Financial Management Systems. DoD Regulation 7000.14-R, volume 1, states that DFAS is to maintain and operate a central double-entry general ledger. The central double-entry general ledger and its subsidiary ledgers and reports serve as the source database for producing financial statements for Military Departments and Defense agencies. However, prior audit reports show that DoD financial accounting systems are not fully compliant with regulatory and statutory requirements. For example, IG, DoD, Report No. D-2000-041, "Deficiencies in FY 1998 DoD Financial Statements and Progress Toward Improved Financial Reporting," November 26, 1999, states that we continued to identify and report deficiencies that prevented favorable audit opinions on DoD financial statements. Favorable audit opinions were not possible because of the lack of adequate general ledger accounting control systems for compiling accurate and reliable financial data. The report also states that until DoD deploys financial management systems that comply with the Chief Financial Officers Act of 1990 and the Federal Financial Management Improvement Act of 1996, we will not be able to perform sufficient audit work to render favorable audit opinions on the DoD financial statements.

Interim Policy and Procedures. The USD(Comptroller) did not promptly issue detailed guidance to enable the Military Departments, Defense agencies, and DFAS to identify or eliminate, as appropriate, the effects of all intragovernmental transactions that occurred within and among Working Capital Fund organizations, DoD, and other Federal agencies. When issued, the guidance was not adequate.

Timeliness of the Guidance. The DoD did not always promptly issue detailed policy guidance to compensate for known systemic problems. Naval Audit Service Report No. 048-99, "Fiscal Year 1998 Department of the Navy Principal Statements and Working Capital Fund Consolidated Financial Statements Eliminating Entries," July 22, 1999, recommended that USD(Comptroller) and the Director, DFAS, provide detailed specific guidance for eliminating intragovernmental transactions to ensure consistency and completeness of financial statement reporting and disclosing. The USD(Comptroller) and the Director, DFAS, concurred with the recommendation. However, "Form and Content of the Department of Defense Audited Financial Statements" was not finalized until October 1999, and guidance on intragovernmental transactions was not finalized before the FY 1999 financial statements were issued.

Adequacy of the Guidance. Because the Under Secretary of Defense (Comptroller) had not finalized its draft guidance, DFAS Headquarters instructed all DFAS centers to use DFAS interim guidance to accumulate and report FY 1999 intragovernmental transactions. However, DFAS interim guidance did not provide sufficient detailed guidance to enable the Military Departments, Defense agencies, and DFAS to identify and eliminate the effects of all intragovernmental transactions that occurred within and among Working Capital Fund organizations, DoD, and other Federal agencies. The guidance requires that the buyers' records for intragovernmental accounts receivable, revenue, and unearned revenue be adjusted to match the sellers' records because DoD presumed that the seller-side information is more complete and reliable

than the buyer-side information. Accordingly, the guidance does not require DFAS to reconcile seller-side and buyer-side information. That practice is contradictory with DoD Regulation 7000.14-R, volume 1, which requires that audit trails including documentation be maintained so that auditors can ensure that the transactions are properly accumulated, classified, coded, and recorded in all affected accounts and later reported in the proper financial statements.

Information Provided to DFAS Cleveland Center. The DFAS Cleveland Center requested the 48 Navy Industrial Fund organizations to modify the report to include accounts receivable, revenue, and unearned revenue for all levels because the central database and the organizations' monthly general ledgers did not contain such detailed information. Our review showed that 60 percent of Navy Industrial Fund organizations did not provide DFAS Cleveland Center with the requested information. Of the 48 Navy Industrial Fund organizations, 19 organizations (40 percent), provided detailed information that enabled DFAS Cleveland Center to identify intragovernmental transactions for levels 1, 2, and 3 for accounts receivable, revenue, and unearned revenue. The remaining 29 organizations (60 percent), provided the information for revenue only. Accordingly, DFAS Cleveland Center had to use the central database or the organizations' monthly general ledgers to identify their accounts receivable and unearned revenue and allocated the entire amounts to level 3. Using monthly general ledgers resulted in overstating accounts receivable and unearned revenue for level 3, and understating accounts receivable and unearned revenue for levels 1 and 2 by the corresponding amounts.

We calculated unallocated accounts receivable and unearned revenue for levels 1, 2, and 3 by applying the ratio of revenues, which was reported by all 48 organizations, to the 29 organizations that did not report accounts receivable and unearned revenue. Our calculation showed that accounts receivable and unearned revenue may have been overstated by an estimated \$352.4 million and \$60.7 million for level 3, respectively. Table 2 shows the summary of revenue data for level 3 reported by the organizations and the estimated overstated amounts for level 3 for accounts receivable and unearned revenue.

Table 2. Summary of Revenue Data for Level 3
Reported by the Organizations and Estimated Overstatements
(dollars in thousands)

<u>Description</u>	<u>No. of Organizations</u>	<u>Accounts Receivable</u>	<u>Revenue</u>	<u>Unearned Revenue</u>
General ledger		<u>\$427,005</u>	<u>\$1,859,719</u>	<u>\$441,596</u>
Complete summary source of revenue	19	21,988	816,254	371,817
Incomplete summary source of revenue	29	0	1,043,465	0
Total	48	<u>21,988</u>	<u>1,859,719</u>	<u>371,817</u>
Not reported in summary source of revenue	29	<u>405,017</u>	0	<u>69,779</u>
Estimated amount that should have been reported	29	52,652	0	9,071
Estimated overstatement		<u>\$352,365</u>	\$ 0	\$ 60,708

Management Control Structure

DFAS Cleveland Center accounting personnel made a commendable effort in identifying and reporting \$21.8 billion in intragovernmental transactions as required by OMB. However, additional improvements in the management control program would improve that the process used to collect and report intragovernmental transactions until DoD accounting systems are able to automatically identify and collect, and report required information on intragovernmental transactions.

Documentation of Methodology. The DFAS Cleveland Center did not adequately document the procedures and methodologies used to accumulate, prepare, and report intragovernmental transactions for the FY 1999 Navy Working Capital Fund consolidated financial statements. General Accounting Office, "Standard for Internal Control in the Federal Government," November 1999, requires that all transactions and other significant events be clearly documented, and the documentation should be readily available for examination. Because DFAS Cleveland Center did not adequately document procedures for preparing and presenting intragovernmental transactions, accounting personnel provided verbal explanations based on their best recollections on how reported balances were computed. In view of the new reporting of intragovernmental transactions required by OMB, DFAS Cleveland Center must develop standard operating procedures to guide accounting personnel in accumulating and reporting intragovernmental transactions. Also, without formal standard operating procedures, DFAS managers and auditors

cannot effectively examine and monitor the process to determine whether all significant transactions were performed in accordance with the standards.

Accuracy Testing. DFAS interim guidance requires DoD accounting centers and DoD Components to work internally and with their customers to ensure that the data that the sellers provided for accounts receivable, revenue, and unearned revenue are complete and accurate. Our review showed that DFAS Cleveland Center did not review the information received for accuracy because it believed that such responsibility rested on the DoD Components and not DFAS Cleveland Center. Accordingly, DFAS Cleveland Center did not establish management controls to examine and test the information obtained from the Navy organizations. However, OMB Circular No. A-123 as Revised, "Management Accountability and Control," June 21, 1995, requires that agency managers use sources of information such as Inspector General and Government Accounting Office reports, including audits, inspections, reviews, or audits of financial statements conducted pursuant to the Chief Financial Officers Act to continuously monitor and improve the effectiveness of management control associated with their program.

We realize that DFAS Cleveland Center is not responsible for the quality of data received from feeder systems generated by the sellers, but it should make an effort to identify erroneous data and attempt to improve the quality of the data. To accurately and completely identify and report all intragovernmental transactions, DFAS Cleveland Center needs to establish procedures to randomly check the information received to ensure that the data were free of material misstatements. Prior audits that the Military Department audit services performed showed that financial information produced by other services was not always reliable. For example, Army Audit Agency Report No. AA 99-255, "FY 1998 Financial Statements Significant Matters, U.S. Army Corps of Engineers, Civil Works," June 2, 1999, states that accounts receivable reported by the Corps of Engineers were not complete, and accounts payable totaling more than \$20 million were not supported by corresponding intra-Corps accounts receivable.

Exchanging the Seller Data With Other Trading Partners. The DFAS Cleveland Center did not exchange the information that the sellers provided for accounts receivable, revenue, and unearned revenue data for all levels with other trading partners. Instead, DFAS Cleveland Center exchanged only level 2 data with other trading partners. That practice is not in compliance with DFAS interim guidance, which requires DoD accounting centers to work with all levels, 1, 2, and 3, to obtain their aggregate accounts receivable, revenue, and unearned revenue and exchange the data with their trading partners.

Adjusting Entries. The DFAS Cleveland Center made eight adjustments to the departmental level general ledger accounts, totaling \$16.4 billion to match the buyers' records to the sellers' records. Of the eight adjustments, seven, totaling \$16.2 billion, were not prepared in accordance with DoD Regulation 7000.14-R, volume 1, which states that the financial transactions on accounting system processes must be adequately supported with pertinent source documents. The adjustments were made because DoD presumed that the data received from the sellers for accounts receivable, revenue, and unearned

revenue were more reliable. Accordingly, DFAS Cleveland Center did not perform reconciliation or document the reason for the variance. Also, at least four adjustments, totaling \$11.7 billion, were not made in accordance with the DFAS interim guidance because certain proprietary and budgetary accounts were omitted from the adjustments. For example, DFAS Cleveland Center reclassified \$8.8 billion in operating expenses between "Public" and "Government" for the proprietary accounts, but did not make a corresponding entry in the budgetary accounts as required by DFAS interim guidance.

Additional Disclosures

DoD Regulation 7000.14-R, volume 6B, states that where individual line items of the financial statement cannot be obtained or a substitution is made from its requirements, the deficiencies will be explained and the reason for the noncompliance annotated in the footnotes. Our review showed that DFAS Cleveland Center did not adequately explain in the footnotes to the financial statements the reasons for the departures from reporting requirements of accounts receivable, unearned revenue, and undistributed collections. DFAS Cleveland Center did not disclose the reason for allocating the entire \$213 million in undistributed collections to level 3. Also, DFAS Cleveland Center did not disclose the reasons for allocating the entire \$405 million in accounts receivable and \$70 million in unearned revenue to level 3 for 29 Navy Industrial Fund organizations as required. Additional disclosures in the footnotes to the financial statements would make the intragovernmental transactions for accounts receivable and unearned revenue more useful and fully compliant with DoD form and content guidance.

Conclusion

The DFAS Cleveland Center made a commendable effort in identifying and reporting \$21.8 billion in intragovernmental transactions for the FY 1999 Navy Working Capital Fund financial statements in accordance with the OMB requirement. However, the intragovernmental transaction amounts reported in the Navy consolidated financial statements were not accurate, were not reliable, and were of limited use. Material weaknesses in identifying and reporting intragovernmental transactions occurred because of the long-standing DoD problems with accounting and financial management reporting systems. In addition, material weaknesses in management controls within DFAS Cleveland Center were identified. USD(Comptroller) and DFAS must promptly issue specific guidance and implement procedures on intragovernmental transactions to allow sufficient time for implementation by the Military Departments and Defense agencies in preparing their financial statements while waiting for a permanent solution.

Recommendations, Management Comments, and Audit Response

1. We recommend that the Under Secretary of Defense (Comptroller) finalize draft policy guidance for intragovernmental transactions to ensure that intragovernmental transactions are accurately and consistently identified and eliminated. Specifically:

a. Require DoD accounting centers and DoD Components to reconcile seller-side and buyer-side information and disclose the unreconciled amounts in the notes to the financial statements.

b. Reemphasize the importance of gathering, reviewing, and exchanging information with other trading partners at all levels to ensure that the data that the sellers provided is complete and accurate.

c. Issue policy guidance in a timely manner to allow sufficient time for the Military Departments and Defense agencies to implement the guidance.

Management Comments. The USD(Comptroller) partially concurred with the recommendations. The USD(Comptroller) did not specifically address the recommendations by number. However, he stated that identification and elimination of intragovernmental transactions is a Government-wide problem, and OMB and the Department of Treasury have not issued sufficient Government-wide guidance to enable accurate reporting and reconciling of those transactions. Also, DoD financial systems are not capable of producing the required information to correctly eliminate intragovernmental transactions.

Given the large number of intragovernmental transactions, relying on an after-the-fact reconciliation would not be feasible. DoD intends to implement automated processes with sufficient automated edits and controls to eliminate the need for after-the-fact-reconciliations. However, until the systems are in place, the USD(Comptroller) is in the process of issuing interim guidance that is "intended to result in a meaningful approximation of intragovernmental transaction amounts and eliminating entries." That guidance will be issued in DoD Regulation 7000.14-R, volume 6B, "Form and Content of Department of Defense Audited Financial Statements."

Audit Response. The USD(Comptroller) comments were partially responsive. We recognize that improving Government financial management systems to capture adequate financial information for intragovernmental transactions needs a Government-wide approach and solution. However, OMB guidance requires reporting entities to reconcile intragovernmental amounts reported in the required supplementary information with their trading partners at least annually. The guidance also requires entities to investigate discrepancies between their intragovernmental account balances and the reciprocal account balances of their transaction partners. Until the reconciliations can be done, the notes to the financial statements should disclose the unreconciled amounts, and the reliability

of the financial statements will be adversely affected. The USD(Comptroller) did not comment on the recommendation to disclose unreconciled amounts in the notes to the financial statements. We request that he provide additional comments on Recommendation 1.a.

2. We recommend that the Director, Defense Finance and Accounting Service Cleveland Center:

a. Maintain records for audit trails in accordance with DoD Regulation 7000.14-R, volume 1, "General Financial Management Information, Systems and Requirements," June 1999, for the amounts of intragovernmental accounts receivable, revenue, and unearned revenue obtained from the sellers for levels 1, 2, and 3.

b. Establish followup procedures that include documenting specific followup actions to obtain detailed summary source of revenue reports and notification of next higher management of the Navy Working Capital Fund organizations if the summary source of revenue reports are not submitted in the requested format.

c. Develop and implement management control procedures to formally document the procedures that Defense Finance and Accounting Service Cleveland Center used to collect, verify, and adjust financial data obtained from other trading partners.

d. Establish procedures to randomly test the information obtained from the sellers for completeness and accuracy to improve the quality of the information received.

e. Collect, exchange, and reconcile seller-side and buyer-side information for all three levels, and disclose reasons for all exceptions in a note to the financial statements.

f. Make accounting adjusting entries for both proprietary and budgetary accounts.

Management Comments. In responding for DFAS, the USD(Comptroller) stated that DoD is committed to implementing interim policies and procedures to provide a "meaningful approximation" of intragovernmental transaction amounts and eliminating entries. The policies will address the existence of audit trails, data integrity, accuracy, and management controls. However, DFAS still intends to rely in part on estimates and percentage allocations of summary balances because of the existing system inadequacies and lack of Government-wide guidance. The DFAS is also working on standard operating procedures to enhance its elimination process and implementation strategies to better ensure that journal vouchers are properly supported and audit trails exist.

Audit Response. We accept the management response that it will issue policies and procedures to address the need for audit trails, data integrity, accuracy, and management controls. However, management comments did not state specific

actions to be taken in response to Recommendations 2.a. through f. Therefore, we request that the Director, DFAS, comment on each of the recommendations in the final report.

Appendix A. Audit Process

Scope

We reviewed the process used to identify and report intragovernmental transactions for FY 1999 Navy Working Capital Fund financial statements, including the balance sheet, Statement of Net Cost, and Statement of Changes in Net Position. Specifically, we reviewed the worksheets that DFAS Cleveland Center used to support the reported intragovernmental transactions of \$21.8 billion.

DoD-Wide Corporate-Level Government Performance and Results Act Goals. In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate-level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following goal, subordinate performance goal, and performance measures:

- **FY 2001 Corporate-Level Goal 2:** Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. (01-DoD-2)
- **FY 2001 Subordinate Performance Goal 2.5:** Improve DoD financial and information management. (01-DoD-2.5)
- **FY 2001 Performance Measure 2.5.1:** Reduce the number of noncompliant accounting and finance systems. (01-DoD-2.5.1.)
- **FY 2001 Performance Measure 2.5.2:** Achieve unqualified opinions on financial statements. (01-DoD-2.5.2.)

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal.

- **Financial Management Area. Objective:** Strengthen internal controls. **Goal:** Improve compliance with the Federal Managers' Financial Integrity Act. (FM-5.3)

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in DoD. This report provides coverage of the Defense Financial Management high-risk area.

Methodology

We reviewed applicable laws, policies, procedures, and regulations related to the preparation and presentation of intragovernmental eliminating transactions for the DoD annual financial statements. We reviewed the DFAS Cleveland Center accounting records and journal vouchers, and we held discussions with the DFAS Cleveland Center accounting personnel responsible for collecting, reviewing, exchanging, and reporting intragovernmental transactions. We compared and analyzed the information that DFAS Cleveland Center obtained from other trading partners with the information reported in the financial statements.

Use of Computer-Processed Data. We relied on computer-processed data from Standard Accounting and Reporting System-Financial and Departmental Reporting and Standard Accounting and Reporting System-Field Level, and Standard Accounting and Reporting System-Headquarters Command Module to conduct the audit at DFAS Cleveland Center. We relied on computer-processed data without performing tests of the system's general and application controls because the process for accumulating and reporting intragovernmental eliminating transactions at DFAS Cleveland Center is primarily a manual process. Not evaluating the controls did not affect the results of the audit.

Audit Type, Dates, and Standards. We performed this financial-related audit from December 1999 through February 2000 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We included tests of management controls considered necessary.

Contact During the Audit. We visited or contacted individuals and organizations in DoD. Further details are available on request.

Management Control Program

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of the DFAS Cleveland Center management controls over accumulating and reporting intragovernmental transactions that occurred within Navy General Fund organizations, the Navy Working Capital Fund, DoD Components, and other Federal Government agencies. Specifically, we reviewed the procedures and controls that DFAS Cleveland Center used to

collect, review, exchange, and report intragovernmental accounts receivable, revenue, and unearned revenue. We reviewed management's self-evaluation applicable to those controls.

Adequacy of Management Controls. We identified material management control weaknesses at DFAS Cleveland Center, as defined by DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996. The DFAS Cleveland Center management controls over accumulating and reporting intragovernmental transactions were not adequate to eliminate the effects of intragovernmental accounting transactions that occurred within the DoD Working Capital Fund organizations and with other Federal Government organizations. Recommendation 2, if implemented, will improve management controls over reliability of the intragovernmental eliminating entries reporting. A copy of this report will be provided to the senior official responsible for management controls in DFAS Cleveland Center.

Adequacy of Management's Self-Evaluation. The DFAS Cleveland Center did not identify the process for accumulating and reporting intragovernmental transactions within its assessable units and, therefore, did not identify or report the material management control weaknesses that the audit identified.

Prior Coverage

The General Accounting Office and the IG, DoD, have conducted multiple reviews related to financial statement issues. General Accounting Office reports can be accessed on the Internet at <http://www.gao.gov>. IG, DoD, reports can be accessed on the Internet at <http://www.dodig.osd.mil>.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Director, Defense Logistics Studies Information Exchange

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Finance and Accounting Service
Director, Defense Finance and Accounting Service Cleveland Center
Director, Defense Finance and Accounting Service Kansas City Center

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
General Accounting Office
National Security and International Affairs Division
Technical Information Center

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International
Relations, Committee on Government Reform

Under Secretary of Defense (Comptroller) Comments



COMPTROLLER

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

MAY 30 2000

MEMORANDUM FOR DIRECTOR, FINANCE AND ACCOUNTING DIRECTORATE,
OFFICE OF THE INSPECTOR GENERAL

SUBJECT: Office of the Inspector General, Department of Defense Draft Audit Report,
"Compiling and Reporting FY 1999 Navy Working Capital Fund Intragovernmental
Transactions" (Project No. DC2000FC-0045.003)

This is in response to the subject Office of the Inspector General, Department of Defense
draft report.

The Department partially concurs with the recommendations. As you are aware and as previously stated on several occasions, the identification and elimination of intragovernmental transactions is a government-wide problem. The Office of Management and Budget and the Department of Treasury have yet to issue sufficient government-wide guidance to enable the accurate reporting and reconciling of these transactions. Additionally, the Department's financial systems currently are not capable of producing the information necessary to be able to perform intragovernmental eliminations properly. Further, in the absence of required government-wide guidance, it is not feasible to attempt to make necessary system modifications without the identification of a government-wide approach and solution. In spite of this, the Department is taking steps to better enable the identification and elimination of intragovernmental transactions. Specifically, the Department is developing interim procedures to aid in the elimination of intragovernmental balances where feasible. The Department believes that this interim guidance will result in the most feasible approximation of intragovernmental balances and eliminations that is realistically achievable in the absence of government-wide guidance and existing system limitations. Detailed comments on the specific recommendations contained in the report are provided in the attachment.

The point of contact for this matter is Ms. Barbara Zientek. She may be reached by
e-mail: zientekb@osd.pentagon.mil or by telephone at (703) 697-8618 (DSN 227-8618).

William J. Lynn

Attachment

OFFICE OF THE INSPECTOR GENERAL DRAFT AUDIT REPORT
"COMPILING AND REPORTING FY 1999 NAVY WORKING CAPITAL FUND
INTRAGOVERNMENTAL TRANSACTIONS"
DATED APRIL 7, 2000
(PROJECT NO. D2000FC-0045.003)

COMMENTS ON RECOMMENDATIONS

RECOMMENDATION 1: The Office of the Inspector General, Department of Defense (OIG, DoD) recommended that the Under Secretary of Defense (Comptroller) finalize draft policy guidance for intragovernmental transactions to ensure that intragovernmental transactions are accurately and consistently identified and eliminated. Specifically, the policy guidance should:

- a. Require the DoD accounting centers and DoD Components to reconcile seller-side and buyer-side information and disclose the unreconciled amounts in the notes to the financial statements.
- b. Reemphasize the importance of gathering, reviewing, and exchanging information with other trading partners at all levels to ensure that the data provided by the seller is complete and accurate.
- c. Be revised and issued in a timely manner to allow sufficient time for the Military DoD agencies to implement the guidance.

OUSDC(C) Response: This office concurs with the need to be able to verify that buyers and sellers are recording and reporting intragovernmental transactions consistently. However, given the large number of intragovernmental transactions, it is not feasible to rely on an after-the-fact reconciliation. The Department's intention is to implement automated processes that contain sufficient automated edits and controls to eliminate the need for after-the-fact reconciliation.

Currently, the Department does not have a transaction-driven general ledger system that captures the information necessary for this reconciliation and disclosure. The Department is working toward an accounting system that will capture this data. Unfortunately, many of the required system enhancements or new systems will not be operational for a few years.

Additionally, this is a government-wide problem. This office is actively involved in interagency workgroups whose goal is to develop a policy to ensure that intragovernmental transactions are identified and eliminated accurately and consistently. The Department will be working with other federal agencies to attempt to develop automated processes that would eliminate the need for manual reconciliation. There are some accounting transactions where reconciliation and elimination may not be possible. First, the sellers are expected to comply with Statement of Federal Financial Accounting Standards (SFFAS) which requires the recording of revenue and

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accounts receivable through the end of the accounting period; however, the SFFASs do not require buyers to record expenses and accounts payable in the same accounting period for intragovernmental transactions. Second, there are instances where the seller records revenue and accounts receivable and the buyers records an asset, rather than an expense. Currently, there is no Office of Management and Budget or Department of Treasury issued mechanism for identifying the amount of intragovernmental asset purchases during the reporting fiscal year.

In the meantime, the Department has drafted and is in the process of issuing interim intragovernmental elimination policy guidance. The guidance will be based on management's assessment of what reasonably can be accomplished to develop a meaningful approximation of the intragovernmental eliminations until applicable government-wide guidance and revised financial systems are implemented. The interim policy guidance will be issued in Volume 6B, "Form and Content of DoD Audited Financial Statements," of the DoD Financial Management Regulation, DoD 7000.14-R.

RECOMMENDATION 2.a. We recommend that the Director, Defense Finance and Accounting Service-Cleveland Center (DFAS-CL):

- a. Maintain records for audit trails in accordance with DoD Regulation 7000.14-R, volume 1, "General Financial Management Information, Systems and Requirements," June 1999, for the amounts of intragovernmental accounts receivable, revenue, and unearned revenue obtained from the sellers for levels 1, 2, and 3.
- b. Establish followup procedures that include documenting specific followup actions to obtain detailed Summary Source of Revenue reports and notification of next higher management of the Navy Working Capital Fund organizations if the Summary Source of Revenue reports are not submitted in the requested format.
- c. Develop and implement management control procedures to formally document the procedures that DFAS-CL used to collect, verify, and adjust financial data obtained from other trading partners.
- d. Establish procedures to randomly test the information obtained from the sellers for completeness and accuracy to improve the quality of the information received.
- e. Collect, exchange, and reconcile seller-side and buyer-side information for all three levels, and disclose reasons for all exceptions in a note to the financial statements.
- f. Make accounting adjusting entries for both proprietary and budgetary accounts.

OUSDC(C) Response: As stated in the response to recommendation 1, the Department is committed to implementing interim policies and procedures which are intended to result in a meaningful approximation of intragovernmental transaction amounts and eliminating entries. While these policies and procedures will address the issues of the existence of audit trails, data integrity, accuracy, and management controls, it must be noted that, due to current system

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* inadequacies, these policies and procedures will rely in part on estimates. In many cases, these estimates will be based on percentage allocations of summary balances. Here again, the Department believes that these interim policies and procedures will result in the most feasible approximation of intragovernmental balances and eliminations in light of existing system inadequacies and lack of government-wide guidance. Specifically, the interim policies and procedures will include standard operating procedures that are expected to enhance the process of eliminating intragovernmental account balances and providing adequate documentation of the process. The DFAS is working on implementation strategies to better ensure that journal vouchers are properly supported and audit trails exist.

Attachment

Audit Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD.

F. Jay Lane
Salvatore D. Guli
Brian M. Flynn
Marvin L. Peek
Hoa H. Pham
Gopal K. Jain
Lukas G. Andreen
Noelle G. Blank

INTERNET DOCUMENT INFORMATION FORM

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Inspector General, Department of Defense
400 Army Navy Drive (Room 801)
Arlington, VA 22202-2884

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